

INDUSTRY INSIGHTS

By Costa Nicodemou and Brett Lennane

Risks grow as property developments grow



This is the third in our series of articles on pre-sales risk mitigation in the residential property development sector, where we detail the process lenders undertake, or at least should always undertake, to analyse and mitigate the risks of pre-sales.

Rigorous analysis of pre-sales risks is vital as residential property developments grow in cost, size and complexity.

Whereas, five to ten years ago, a large development may comprise 100 units, it's not unusual today for projects to have over 200 units. In fact, some recent projects have over 1,000 units.

In March 2017, APRA wrote to Authorised Deposit-taking Institutions (ADIs) following a thematic review of Commercial Property Finance practises. APRA said "the thoroughness of analysis of presales achieved for particular transactions was sometimes lacking".

The implication for ADIs is they should use a sophisticated model that quickly, yet rigorously, helps them analyse pre-sales in complicated developments.

We believe non-bank lenders should also apply best practice.

What is acceptable due diligence?

Based on our experience and enquiries, we believe lenders will spend around 12-hours reviewing and qualifying the pre-sales of a medium size residential property development, required as a condition precedent of finance. As the size of the development increases, so will the time spent on the review.

This due diligence process typically involves:

- ▲ 2 hours inspecting the display suite and marketing materials
- ▲ 30 minutes obtaining pre-sales information from the client
- ▲ 30 minutes reviewing the pro-forma contract
- ▲ 90 minutes reviewing the front pages of contracts
- ▲ 2 hours preparing the sales schedule
- ▲ 2 hours qualifying the buyers
- ▲ 30 minutes comparing the application with the approval and lending policies
- ▲ 2 hours signing-off the pre-sales and dealing with variances
- ▲ 30 minutes sending the package to (and instructing) the lawyer
- ▲ 30 minutes reviewing the lawyer's certification of qualifying pre-sales

Is this sufficient to mitigate the underlying take-out risk and demonstrate market acceptance?

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Qualifying criteria vs risks

Lenders will have a range of qualifying criteria, or policies, that apply to pre-sales supporting a development finance loan. These policies are in place to address the specific risks faced and include:

- ▲ Pre-sale contracts must be 'arms-length', which means the purchaser is not related to the developer. This policy ensures the borrower doesn't use associates to activate funding;
- ▲ Contracts must be 'unconditional'. They should not contain references to side deeds or rebates that can distort market values;
- ▲ Limits on overseas buyers, as the lenders generally consider these sales to have a higher fall-over risk and to be difficult to enforce; and
- ▲ Contract prices must be at or above valuation with 10% cash deposits. This will give the lender confidence in the value of the underlying security.

Such policies are basic, prudent lending practice. All the banks have similar policies. Generally, non-bank lenders have less sophisticated policies.

Analysis step 1 – Obtaining the information

A lender's first step in analysing pre-sales is to obtain the relevant information about them. For each pre-sale, this will include (but is not limited to):

- ▲ property attributes – aspect, layout, level size, number of bedrooms, bathrooms and parking spaces
- ▲ purchaser details – name, address, contact details, domicile and lawyer
- ▲ sale particulars – price, agent, status (exchanged, under offer or unsold), special conditions (if any) and deposit (amount, type and holder)
- ▲ summary – aggregate price vs valuation, sales number and rate of sale, balance unsold and lending ratios.

The lender will also identify issues that require clarification, such as sales by lot type (and what type is not selling), whether the buyers can be identified and are local or foreign, and whether there are any rebates or if pre-sales are at a premium/discount to valuation.

Analysis step 2 – Pre-sales modelling

Once they have obtained key information on pre-sales, most lenders will use a spreadsheet to aid analysis.

Modelling pre-sales enables the lender to:

- ▲ summarise, illustrate and highlight key data;
- ▲ quickly understand specific areas of risk;
- ▲ locate risks at the individual dwelling level; and,
- ▲ speed up analysis and reporting to credit/investors.

Most lenders have simple spreadsheets that tabulate elements such as unit numbers, purchaser's name, deposit, contract price, settlement date, and any conditions.



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BRI Ferrier promotes the use of the Plinth model, which has a much more sophisticated pre-sales analysis module. It is available free-of-charge. BRI Ferrier provides assistance to users of the model. We also provide due diligence outsourcing services tailored to individual lenders' needs.

This model considers around 20 different elements to help lenders understand pre-sales risks. These include all the elements on a pre-sale contract and every major attribute in a development. The model prompts users for information about the purchaser's status (owner-occupier, investor etc.) and the commission rate payable on the sale. These two important elements of pre-sales are not noted on pre-sale contracts.

The model helps to identify issues with rates of sales, timing of sales, high and low rates per square metre and risk concentrations.



Analysis step 3 – Legal due diligence

The third step in analysing pre-sales involves a lawyer certifying qualifying pre-sales.

The lawyer will examine the pro-forma contract for enforceability (considering technical issues), noting special conditions (inclusions, rebates and side agreements) and any rescission clause, sunset date or assignment clause.

They will also review the front pages of contracts and the certification from the borrower's solicitor confirming that all sales contracts use the pro-forma contract.

However, the lawyer will often only analyse a sample of pre-sales' documentation. The major trading banks typically require that 25% of pre-sales are assessed. The lawyer determines the sample set.

We also suggest that lawyers use a comprehensive model (such as Plinth) to identify the "riskiest" pre-sales. These pre-sales should be included in the sample set, minimising the lawyer's own risk when reporting on qualifying pre-sales.

Analysis step 4 – ongoing monitoring

The final step in pre-sales risk mitigation involves longer-term monitoring of ongoing risk.

Lending on the basis of pre-sales is not a 'set and forget' type of arrangement, because projects play out over a two-to-three-year period.

A lender should continually monitor the market, reviewing media, auction clearance rates, clients, agents, valuations and other information sources (such as Domain.com.au and RealEstate.com.au).

They will need ongoing updates from the developer, such as the value and number of pre-sales still on foot and the value and number of new sales.

They will also update their pre-sales model for changes. For annual reviews, they will re-assess the pre-sales status and update loan approvals as required.

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Our broad experience and industry resources equips us to assist in the most complex situations. Please contact [Costa Nicodemou](#) or [Brett Lennane](#) to find out how we can support you.

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With over 160 staff and eleven practices in Australia, New Zealand, Hong Kong and the United Kingdom, we work with clients of all types – from individuals, sole traders and small businesses to public corporations and government entities.

We also work with financiers, solicitors, accountants and creditors to address the needs of all stakeholders when businesses face financial challenges.

BRI Ferrier's team has the expertise and resources to meet any client challenge. By combining our skills and enthusiasm, we achieve the best possible outcomes in all cases where a business experiences financial distress.

How BRI Ferrier can help

BRI Ferrier can assess your current situation and advise on a path forward to minimise further risk.

Early intervention is often the key for a successful restructure of your business. If you or your client is experiencing financial challenges then don't delay, contact us today.

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